

No. 11976

**In the United States Court of Appeals
for the Ninth Circuit**

GRACE BROS., INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES*

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 18-30) is reported in 10 T.C. 158.

JURISDICTION

This petition to review the determination of the Tax Court involves a deficiency in income and excess profits taxes for the year 1943. A deficiency of \$114,190.49 for excess profits tax and \$10,740.53 for declared-value excess profits tax, and an overassessment of \$10,731.62 for income tax was determined by the Commissioner of Internal Revenue, who on September 20, 1945, notified the taxpayer thereof, pursuant to Section 272 of the Internal Revenue Code. (R. 10-12.) The taxpayer, on December 10, 1945, pursuant to Section 272, Internal Revenue Code, filed a petition with the Tax Court of the

United States to review the Commissioner's determination (R. 1), and thereafter on February 24, 1947, filed an amended petition in which it alleged that it had overpaid its excess profits taxes for the year 1943 by the amount of \$23,913.11 (R. 4-9). On March 19, 1947, the Commissioner filed an answer to the amended petition denying the taxpayer's claims. (R. 16-18.) On January 27, 1948, the Tax Court promulgated its findings of fact and opinion (R. 18-30) and on April 5, 1948, entered its decision determining a deficiency in the taxpayer's excess profits taxes for the year 1943 in the amount of \$124,073.01 and an overpayment in declared-value excess profits tax in the amount of \$240.04 (R. 31).

The taxpayer on June 14, 1948, pursuant to Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, filed a petition for review by this Court of the decision of the Tax Court. (R. 32-38.)

QUESTIONS PRESENTED

1. Whether the Tax Court erred in holding that no portion of the consideration received by the taxpayer for the sale of its wine inventory represented payment for the good will of the taxpayer's business.

2. Whether the Tax Court erred in holding that the transaction under consideration was not the disposition of a "unitary business" but rather the sale of particular assets which must be treated as ordinary income.

3. Whether the Tax Court erred in holding that the taxpayer's stock in trade was not converted into a capital asset by virtue of its decision to discontinue business.

STATUTES AND REGULATIONS INVOLVED

These are found in the Appendix, *infra*.

STATEMENT

The facts as found by the Tax Court (R. 20-24) may be summarized as follows:

The taxpayer, a California corporation with principal place of business at Santa Rosa, California, keeps its books on an accrual basis of accounting and filed its 1943 income tax returns, prepared on that basis, with the Collector of Internal Revenue for the first district of California. In 1943 and for many years prior thereto it has engaged in various enterprises, including farming, grape growing and the manufacture and sale of wines and beer. All of its stock was owned by its president and manager, Joseph T. Grace, of Santa Rosa, a man active in numerous civic, financial, industrial and agricultural enterprises, and for over twenty years a vice-president of the Bank of America. (R. 20.)

In 1921 the taxpayer purchased a wine-manufacturing plant, long known to the trade as DeTurk Winery. It operated the plant until 1943, producing from grapes grown by it or bought from others sweet and dry types of wine and some brandies which it sold to a regular clientele partly in bottles bearing the label "DeTurk Winery" and partly in barrels to wholesale customers who bottled and sold it under their own labels. "The DeTurk Winery, Established 1876" appeared above taxpayer's name on its invoices. The product was accepted by the trade as a wine of high quality; it was successfully marketed, and the net profit from its sale for the years 1936-1942 was as follows (R. 20-21):

| | | | |
|-----------|-------------|-----------|-------------|
| 1936..... | \$26,610.18 | 1939..... | \$16,100.84 |
| 1937..... | 33,184.93 | 1940..... | 10,459.86 |
| 1938..... | 20,377.92 | 1941..... | 7,995.20 |
| | | 1942..... | 18,959.53 |

In 1941 the taxpayer's sales were 157,518 gallons of dry wine in bulk and 8,888 gallons in bottles at an average

price of 22.6 cents a gallon, and 46,943 gallons of sweet wine in bulk and 12,443 gallons in bottles at an average price of 37.2 cents a gallon. In 1942 it sold 114,046 gallons of dry wine in bulk and 7,028 gallons in bottles at 22.2 cents a gallon, and 46,009 gallons of sweet wine in bulk and 10,268 gallons in bottles at 36.8 cents a gallon. During the years 1936-1942 its average investment in this section of its business was \$150,000, of which roughly \$60,000 was attributable to the plant and \$90,000 to inventory. As dry wine should be held two years or more and red wine one year for aging, a substantial inventory was kept in stock. (R. 21.)

Finding his numerous activities excessive, Grace decided late in 1942 to discontinue the wine business, and the taxpayer limited its production for that year to 4,959 gallons extracted only from the grape supply grown by it, whereas normally its annual production was about 200,000 gallons. Nonetheless it had an inventory of 522,761 gallons at the end of the year, produced in 1942 and prior years. (R. 21.)

In November 1942 Grace advised L. A. Weller, an old acquaintance and vice-president of Garrett & Company, Inc., of New York, that he intended to abandon the wine business. Weller manifested interest, asking the quantity of wine available for sale; saying that his firm's lease on a California plant was about to expire, and making inquiry about a lease of the DeTurk Winery and the possibility of installing in it certain machinery. (R. 21-22.) After Weller's return to New York, Garrett & Company requested Grace by telegram of December 28, 1942, to submit details if "interested in selling your inventory and leasing winery." Grace replied the following day "that we have several purchasers for our inventory and lease of winery and distillery"; offered specified quantities of several types of wine at 40, 55, 60 and 65 cents a gallon, respectively,

and a lease "of winery, distillery and bonded warehouse" for five years at an annual rental of \$12,000. In further negotiation by telegraph, Grace inquired what part of the inventory was of interest, adding (R. 22):

* * * anxious to close deal immediately to get part of sales in this year income tax returns * * *.

Agreement was reached by telephone and confirmed by a telegram of Garrett & Company to Grace on December 31, 1942. By the contract Garrett & Company agreed to purchase all of the taxpayer's wine at 50 cents a gallon; to pay 20 per cent of the purchase price immediately, and to lease the winery for five years at \$10,000 annual rent. On the same day the taxpayer delivered 104,000 gallons; received \$52,000 therefor from Garrett & Company, and reported the profit on its 1942 income tax return. (R. 22.)

There remained 418,761 gallons of wine, carried on the taxpayer's books at \$79,046.33, consisting of 248,635 gallons of dry wine and 170,126 gallons of sweet wine. During 1943 this entire stock was delivered and the taxpayer received \$124,317.50 for the dry wine and \$94,862.41 for the sweet wine. The price paid for the latter was by agreement somewhat in excess of 50 cents a gallon because 73,628 gallons contained a higher sugar content than required by California standards. Garrett & Company also agreed to purchase 600 wine barrels at \$4 each. On January 20, 1943, the parties signed a detailed memorandum of the agreement, setting forth its terms as above described, and on January 30 they signed the contemplated contract of lease. By its terms the taxpayer leased to Garrett & Company the premises of the winery "together with all winemaking machinery and equipment located therein" and the right to use the spur track of a railroad on the east side of the property.

The annual rental was fixed at \$10,000; the term of the lease at five years with right of renewal for an additional five years. The lessee agreed to keep the equipment in good working order and in a reasonable state of repair; it reserved the right to remove all machinery and equipment installed by it within sixty days of the lease's expiration. The lessor reserved a small office and the use of well water on the leased premises for its adjoining cold storage plant. It agreed to carry fire insurance except on equipment installed by the lessee, and in case of damage to make repairs with due diligence. If the winery should be totally destroyed, the lease was to terminate. (R. 23-24.)

In giving possession to Garrett & Company the taxpayer surrendered its permit to manufacture and sell so that the lessee could procure a permit to operate on the premises; turned over to the lessee all its wine stocks, cooperage and labels, its list of customers and its regular staff of eight or ten experienced employees. Thereafter neither the taxpayer nor Grace engaged in making or selling wines. Garrett & Company paid rent under the lease to the end of April, 1944, when the parties terminated it by mutual agreement. On April 15, 1944, the taxpayer sold the winery to Taylor & Company for \$150,000. Taylor & Company was not a subsidiary of, or owned by Garrett & Company. (R. 24.)

In computing the taxpayer's income tax, declared value excess profits tax and excess profits tax for 1943, the Commissioner determined (1) that the taxpayer realized ordinary income of \$140,133.58 from the sale of wine in 1943, and not a capital gain in that amount as reported by it; and (2) that the taxpayer in 1943 realized a capital gain of \$99,002.64 from the sale of the winery. (R. 24.) Only the first of these determinations was disputed in the Tax Court, the parties having agreed that the gain arising from the sale of the winery

was taxable in 1944. (R. 30.) The Tax Court upheld the Commissioner's determination as to the first issue (R. 30) and from that decision the taxpayer petitioned for review.

SUMMARY OF ARGUMENT

The taxpayer during the latter part of 1942 sold its wine inventory and leased its winery plant to a competing wine manufacturer. The agreement was embodied in a written memorandum and a lease. The Tax Court held, despite the taxpayer's contention to the contrary, that it was not intended that anything more be sold other than as embodied in these documents. Accordingly, the gain realized on the sale of the wine inventory was to be reported as ordinary income and not long term capital gain under Section 117, Internal Revenue Code. No support is found in the record for the taxpayer's argument that it was intended to convey its good will, valued at \$100,000, except the unsupported testimony of the taxpayer's sole stockholder. Moreover, the record is replete with evidence which contradicts that testimony and squarely supports the Tax Court's conclusion regarding the character of the transaction.

The taxpayer's alternative contention that the transaction involved the sale of its business as a unit rather than as a sale of separate assets was likewise found by the Tax Court to be lacking in factual support and analysis of the record discloses that this conclusion is clearly correct.

The Tax Court similarly rejected the taxpayer's argument that a decision to terminate its business had the effect of converting its stock in trade into a capital asset, the sale of which yielded capital gain. No such conversion could take place in view of the nature of the asset, i.e., stock in trade, and in any event, the asset was not held as a capital asset for more than six months so as to yield capital gain.

ARGUMENT

The Tax Court correctly held that the taxpayer sold its wine inventory and leased its winery and that the gain derived therefrom was ordinary income and not long term capital gain

During the latter part of 1942 the taxpayer, a corporation engaged in the manufacture and sale of wine, negotiated with a representative of Garrett & Company, a competing wine manufacturer, for the sale of its wine inventory and the lease of its winery plant. These negotiations were concluded on December 31, 1942, following a series of telegrams and telephone conversations. The results of the parties' agreement were embodied in a memorandum dated January 20, 1943, and a lease dated January 30, 1943.

The Tax Court held that the written agreement dated January 20, 1943, reflected the complete understanding of the parties and despite the taxpayer's contention to the contrary, nothing (such as good will) was sold or intended to be sold except as therein stated. The Tax Court likewise rejected as lacking factual support the taxpayer's alternative contention that the transaction involved the sale of its entire wine business as a unit (and not separate assets) and should therefore be treated as giving rise to capital gain. Lastly, the Tax Court rejected the argument that the taxpayer's decision to give up its business converted its stock in trade to a capital asset, the sale of which yielded capital gain. All three contentions are now advanced on this appeal.

A. The Tax Court correctly held that no part of the consideration received by the taxpayer was for the sale of its good will

The taxpayer's chief contention is that at least \$100,000 of the \$219,179.91 received by it from Garrett & Company in 1943 under its contract for the sale of

wine represented consideration for the sale of its good will. The Tax Court held (R. 27) that on the evidence it was “unable to make such a finding or to hold that the sale contract covered any more than its terms indicate”. We submit this conclusion to be clearly correct and—in the light of the record—phrased even more conservatively than necessary.

Whether the taxpayer contracted for the sale of its good will presents a pure question of fact. Under familiar rules respecting the scope of judicial review, the findings made by the Tax Court in this regard may not be set aside unless “clearly erroneous”. Section 1141(a), Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess.; Rule 52(a), Federal Rules of Civil Procedure. It is the function of the Tax Court to weigh the evidence, to judge the credibility of the witnesses and to draw inferences from the facts. It was not obliged as the taxpayer urges (Br. 20-22) to reach its conclusion exclusively on the basis of the testimony of the taxpayer’s sole stockholder (Joseph T. Grace, hereafter referred to as Grace) merely because it may have been uncontradicted by other oral testimony. *Birnbaum v. Commissioner*, 117 F. 2d 395 (C.C.A. 7th); *Cohen v. Commissioner*, 148 F. 2d 336 (C.C.A. 2d); *Jergens v. Conner*, 125 F. 2d 686 (C.C.A. 6th); *Greenfeld v. Commissioner*, 165 F. 2d 318 (C.C.A. 4th); *O’Laughlin v. Helvering*, 81 F. 2d 269 (App. D. C.); *O’Dwyer v. Commissioner*, 110 F. 2d 925 (C.C.A. 5th).

Even conceding the existence of a rule which accords weight to the uncontradicted though unsupported testimony of an interested witness where the facts otherwise permit the conclusion for which his testimony is offered (*Foran v. Commissioner*, 165 F. 2d 705 (C.C.A. 5th)) that rule is strictly limited to cases in which the uncontradicted testimony of unimpeached witnesses is con-

sistent *with facts actually proved* and has no application to a case in which every other proven fact is inconsistent with the so-called uncontradicted testimony (*Quock Ting v. United States*, 140 U. S. 417, 420-421, 422). And in the context of this case we submit that the rule is completely inapplicable because every proven fact tends to discredit and make wholly improbable the testimony so strongly relied upon.¹ The Tax Court in its opinion recognized the numerous weaknesses of Grace's testimony, and analysis of the record discloses numerous inconsistencies so basic as to justify the conclusion that not only was the Tax Court's decision not "clearly erroneous" but that it was the only correct one.

The form in which the parties here chose to mold the transaction is plainly disclosed by the documents which they executed. They are the best evidence of what they intended to do and of what they accomplished. Apart from the testimony of Grace, the facts prove a sale barren of anything but the taxpayer's wine inventory (and about 600 wine barrels). Not a word even implying the sale of something in addition thereto can be found in the telegraphic communications which pre-

¹ Since the oral testimony of Grace (R. 52-92) tends largely to supply alleged omissions and to contradict the express terms of the written contract of sale and lease entered into by the taxpayer and Garrett & Company there would appear to have been a sufficient basis for the complete rejection of such testimony by the Tax Court under the familiar rule that all prior and contemporaneous oral understandings are merged in a written contract which purports to reflect the entire agreement of the parties. *Gaylord v. Commissioner*, 153 F. 2d 408, 415 (C.C.A. 9th); *Jurs v. Commissioner*, 147 F. 2d 805, 810 (C.C.A. 9th); *Sherman v. Commissioner*, 76 F. 2d 810 (C.C.A. 9th). However, having permitted the taxpayer's principal stockholder so to testify the Tax Court manifestly was under no obligation to give conclusive effect to such testimony and to disregard the express terms of the written contract embodying their agreement. *Woodall v. Commissioner*, 105 F. 2d 474 (C.C.A. 9th); *Boland v. Commissioner*, 118 F. 2d 622 (C.C.A. 9th); *Jurs v. Commissioner*, *supra*; *Gaylord v. Commissioner*, *supra*.

ceded the execution of the formal contract of sale; or in the memorandum contract itself; or in the lease of the winery; or in letters subsequent to the sale between the parties. Moreover, the contrary is strongly indicated not only in all of the documentary evidence but also in the inability of Grace to explain how the amount of good will allegedly included was computed on the separate items of the wine inventory; in the absence of evidence that the December 1942 market prices of the various wines sold by the taxpayer were lower than the prices quoted; in the attempt of Grace to exaggerate the importance of the so-called "organization of key men" transferred to the purchaser; in the cancellation by Garrett & Company of the lease after approximately one year of occupancy; in the failure of the taxpayer to show that the trade name allegedly contracted for was ever in fact used by the purchaser; and in the utter lack of documentary evidence to corroborate any of the claims of the taxpayer.

Each of the above-named items of evidence will be separately analyzed in the following discussion.

The telegraphic communications. Grace testified (R. 53, 55-56) that prior to the interchange of telegrams between him and Garrett & Company he met Mr. L. A. Weller, the executive vice president of the latter company, in Fresno and that at that time preliminary discussions were commenced by Weller's statement that he had heard that Grace had "some wine to sell" (R. 53). Grace said that he told Weller that he wanted to get out of the wine business and (R. 53-54)—

I wouldn't sell the wine inventory unless I sold everything in connection with the wine business, that is, winery and wine inventory and the good will in it—everything that had to do with it * * *.

In addition, Grace estimated that the winery was worth \$125,000 and the wine inventory and good will, \$250,000, a total of \$375,000. (R. 54.)

Grace, in addition, testified that Weller also said² (R. 56)—

I can give you what you ask for your wine and everything that goes with it, the good will, which would be equivalent to \$250,000. * * * If I give you 50 cents a gallon, that will give you what you are asking.

It is perhaps fair to state that these two portions of the testimony are the crux of the taxpayer's case that the parties contracted for the sale of good will.³ Yet the contradiction of this testimony by the proven facts is so marked as easily to justify any doubts the Tax Court might have had as to Grace's credibility or as to the taxpayer's failure to support its case by evidence. Thus, for example, despite Grace's alleged initial refusal to sell any wine inventory unless everything connected with the business, including the winery, was *sold* the fact is that the winery was merely *leased* to Garrett & Company. Grace's attempt to equate the leasing of the winery to a sale (R. 55), on the theory that the investment by Garrett in the winery would make it uneconomical for Garrett not to purchase, topples when the record discloses (R. 106-107) that in less than 15 months Garrett surrendered the lease and abandoned

² This alleged statement of Weller apparently is deemed crucial by the taxpayer since in its "Summary of pertinent facts" (Br. 17), it is presented and italicized as if it were a fact of record or at least as if it were Weller's *testimony* rather than, as is the case, the hearsay testimony—self-serving in the extreme—of Grace himself. (Weller, it should be noted, had died prior to the date on which this case was tried in the Tax Court. (R. 79.))

³ These statements also provide the chief basis for the alternative argument (Br. 39-42) that the transaction involved the sale of a "unitary business".

the winery, and it was then sold by the taxpayer to a third party.

Further, as was stressed by the Tax Court (R. 26-27), it taxes the credulity that parties who have discussed the sale of a wine inventory and intended thereby to sell a going business inclusive of good will valued at \$100,000, for a total price of \$250,000 (or in the alternative for a compromise price of 50 cents a gallon) should never thereafter in their telegraphic communications or in their formal contract of sale have referred to such good will, to the price of \$100,000, or to anything other than the wine itself. Rather, the taxpayer's first formal telegraphed offer to sell (R. 71-72) carefully listed its entire wine inventory according to type and price (40 cents and 65 cents per gallon). The subject matter of the telegram was otherwise limited to the statement that the taxpayer had (R. 71) "several purchasers for our inventory and lease of winery and distillery. Also bonded warehouse". There was not a word about the sale of the so-called "business" of the taxpayer. A second telegram sent that same day added other types of wine to the inventory listed in the first telegram (at 60 cents per gallon).

Garrett & Company responded with a suggestion that it merely take a *portion* of the wine inventory—a suggestion, of course, wholly inconsistent with the purchase of the taxpayer's "business". Significantly, the taxpayer responded by asking (R. 73) "What part of inventory are you interested in. Stop. What are your ideas on rental of plant". The next telegram dated December 31, 1942, seems to provide a conclusive showing of the parties' intention, for, in it, Garrett & Company confirmed the telephonic agreement into which the parties had entered (R. 73-74) "relative to lease of winery and purchase of bulk wines".

We submit that this interchange of telegrams wholly

belies Grace's testimony, and unquestionably justified the Tax Court in concluding (R. 25) that it could not find "an offer upon the evidence adduced" to sell not merely the wine but also the good will of the business.

The memorandum dated January 20, 1943. Following the extensive negotiations during the last few days of December 1942 resulting in the telegraphic contract, a lengthy memorandum dated January 20, 1943 (R. 111-116), was prepared by Grace or his attorney in accordance with Grace's ideas and decisions (R. 81). This was signed by Weller and Grace. The memorandum, in summary, restated the understanding of the parties, as evidenced by the telegrams, that the taxpayer "has sold and said Garrett & Company, Inc., has bought as of December 31, 1942, 104,000 gallons of wine situate at DeTurk Winery, at Santa Rosa, California, for the sum of \$52,000.00 * * *" and the taxpayer (R. 111)—

agrees to sell and said Garrett & Company, Inc., agree~~a~~ [sic] to buy, all of the remainder of that certain inventory of wines now on hand at said DeTurk Winery consisting of approximately 416,000 gallons, including both sweet and dry wines, at the purchase price of fifty cents (50¢) per gallon.

Further provision was made for the payment of the balance of the wine as shipped. It was also stated that it was understood "that the inventory of wine sold approximates 520,000 gallons" (R. 112), and that 80,000 gallons of wine were to bear an increased price over and above the purchase price of fifty cents per gallon. In addition, provisions were made with respect to other portions of the inventory not up to California standards of quality (R. 112-113), for the payment of taxes assessed against a certain portion of the wine inventory and for the payment of fire insurance premiums on the wines by the buyer (R. 113). Additional provision was

made for the sale of approximately 600 wine barrels on hand at the winery at the price of \$4 each. There then followed elaborate provisions with respect to the lease of the DeTurk Winery and the adjoining property.

It seems not unfair to suggest that if this agreement—so painstakingly prepared and presumably with legal assistance—was intended to embrace a transaction whereby an entire business was to be transferred to the purchaser it fell far short of its purpose. The agreement discloses a most meticulous concern with the wine inventory and with nothing more.

Presumably if there were to be a transfer to the purchaser of the seller's stock of bottles (R. 58), its list of customers (R. 61), its highly trained "organization". (R. 61) and its "cooperage" (R. 24), some mention of these items would have been made. Presumably, too, there would have been some reference to the obligations incurred by the taxpayer and its stockholders in connection with such a sale. One might reasonably have expected to find a provision under which the taxpayer and its stockholders agreed not to compete with the purchaser in the wine business, or to use the trade name and label, or the list of customers assigned, or to "pirate" the "key men" of the organization. Nor would it be unusual to find some reference to the disposition of the taxpayer's accounts receivable and payable. But on a record barren of a single reference to ought save the wine inventory, the conclusion is a necessary one that the mere testimony of Grace must fall under the weight of the documentary evidence presented.

The lease dated January 30, 1943 (R. 116-120). Here again, we have documentary evidence supporting the Tax Court's conclusion. The lease gave possession to Garrett of the premises on which the DeTurk Winery was located as well as (R. 117) "all-wine making ma-

chinery and equipment located therein and the right and privilege to use the spur track" of a railroad running alongside of the plant. A transfer of an "entire business" to a purchaser would appear to be incompatible with the mere lease of all the wine making machinery. This inconsistency takes on added significance when viewed against the fact, suggested by the record, that the location and size of the manufacturing plant are of some importance in the wine making industry. (R. 55-56.)

The L. A. Weller Letters (131-138). The taxpayer, as shown, was unable to offer a scintilla of written evidence to buttress its case. Moreover, in each of the letters written by L. A. Weller regarding the transaction there is a corresponding failure to mention anything other than the sale of the wine inventory. Further, in the letter dated November 5, 1946 (R. 135-138), there is a clear-cut contradiction of Grace's testimony regarding one aspect of the transaction which bears materially upon the whole. Grace, it will be remembered, testified (R. 53-54) that in the personal conversations between the two prior to the interchange of telegrams he had informed Weller that the wine inventory would not be sold unless everything in connection with the business, including the winery and the good will, were also sold; and that the winery was worth \$125,000, the wine inventory and good will, \$250,000, a total of \$375,000 for everything. Weller's letter stated (R. 135) "I find nothing in the exchange of our telegrams about his wanting to sell us the plant or do I have any recollection of it * * *." Certainly the failure to recall the reference to the sale of the winery at the price of \$125,000 in the very same conversation in which the sale of the good will was allegedly discussed casts a strong shadow of doubt upon Grace's testimony regarding that conversation. Beyond ques-

tion, it presents a material contradiction upon which a trial court may base its conclusion to disregard other portions of the challenged testimony.

Further analysis of the Weller letter shows no mention of any sale of the "business" or good will. On the contrary, the sale is specifically referred to as a "deal * * * for the Santa Rosa wine and plant lease." (R. 135.) Thus, the only other person whose description of the sale could conceivably have accorded with that of the taxpayer's failed in any respect so to do.

The inclusion of good will in the telegraphed offer. Grace apparently recognized the rather strong conflict between his testimony that a total price of \$250,000 had been fixed by him for the entire wine inventory, inclusive of good will, and the fact that in the offer made subsequently thereto to Garrett by telegram dated December 28, 1942 (R. 71-72) the separate types and grades of wine were listed with prices of 40 cents, 65 cents and 60 cents. At these prices the inventory would have sold for \$280,000. In addition, Grace had testified that the parties had generally agreed on a price of 50 cents per gallon although the prices as offered averaged about 57 cents per gallon.⁴ Grace attempted to explain away these inconsistencies on the ground that the prices were roughly computed to include the good will sought to be sold. (R. 83.) Yet on cross-examination (R. 88-89) he admitted that the listing of prices was not done on the basis of including good will with reference to each type of wine. Again, a self-contradiction greatly weakening the probative force of his testimony.

⁴ The trial court's recognition of this conflict in Grace's own testimony is indicated by its cogent questions (R. 83) with reference to the fluctuation of prices on different types of wine as compared with a flat price on all wines and the difference between the figure of 50 cents per gallon and the average of the prices listed in the offer of December 28.

Market prices of wines in December 1942. The taxpayer's effort to contradict the express terms of the agreement depends, as just shown, in large measure upon a showing that the price or prices quoted for the wine inventory included a substantial provision for good will. Corroborative evidence thereof might possibly have been found in the fact—if it was a fact—that the market prices for the taxpayer's grades of wine in December 1942 were substantially lower than the prices quoted to Garrett. For this reason it seems clear that the Tax Court was quite justified in concluding (R. 27) that it was significant that the taxpayer—

offered no evidence of the market price of its grades of wine in December 1942 apart from Grace's general testimony that the price paid by Garrett & Co. was excessive by \$100,000.

The taxpayer, however, urges (Br. 36-37) that this omission is supplied by that portion of the stipulation of facts (R. 103-108) which showed the average prices at which the taxpayer had been selling its wine in the year 1942; that applying such average price to the number of gallons sold there would have been received about \$100,000 less than the amount actually received. This the taxpayer now offers in lieu of the vitally essential evidence not elsewhere to be found in the record. The short answer to this is that an average price at which wine is sold during the year gives no possible basis on which to determine what the price of such wine is at any one point of the year. Obviously, the price in December may so far exceed the price during the early part of the year⁵ as to completely destroy the probative value of such evidence to support

⁵ Some indication that such, in fact, was the situation in 1942 may be found in Grace's testimony that conditions [in June 1942] "were getting better". (R. 60.)

the conclusion desired by the taxpayer. Yet the taxpayer further argues (Br. 36-37) that the Commissioner "was necessarily fully informed of the price at which wine was sold in December, 1942" and that "there can be no doubt that" he "would have introduced such fact in evidence". But we think it almost too plain to require statement that the burden of presenting evidence in this case lay with the taxpayer and not with the Commissioner. That burden—which it so obviously failed to carry—may not now be supplied by mere argument.

The organization of "key men". In addition to the direct contradiction within Grace's testimony there is also to be found a rather flagrant exaggeration obviously offered for self-serving motives. For instance, Grace sought to create the impression that the employees of Grace & Company were an organization of "key men" with valuable and extensive training in the "art of wine making" (R. 57) which enhanced the value of the business (R. 52-53, 90) and if transferred to the purchaser was to be included in any consideration of the value of the taxpayer's good will.⁶ On cross-examination he disclosed for the first time that this valuable organization consisted of "three or four key men". (R. 77.) The "organization" included "about eight, maybe ten" men to do the ordinary work. (R. 77.) It is rather informative in this connection to refer to Exhibit 4-D. (R. 121.) There a breakdown of the taxpayer's winery operations for 1942 discloses that the only labor or salary costs incurred were \$6,134.32 for all operating labor, \$1,173.70 for all bottling labor and \$3,398.80 for all salaries and

⁶ Since the decision to remain with Garrett & Company rested with the employees themselves (cf. Grace's testimony, R. 57) it would appear questionable whether the taxpayer had the power or right to "transfer" to Garrett its "organization" by any means which would entitle it to include that organization in its good will evaluation.

commissions paid as selling expenses. Thus this "valuable organization" of key men (some 3 or 4, or 8 or 10) must necessarily have received but a small portion of the entire \$10,700 paid throughout 1942 for all types of labor, salary and commissions. Testimony of this character, indicating a deliberate effort to color the facts, suggests the substantial infirmity of the taxpayer's evidence.

The DeTurk trade name. As a measure of the value of the taxpayer's good will, testimony was offered to the effect that the wines produced by the DeTurk Winery were above average (R. 43) and that the DeTurk Winery, which sold its product under the DeTurk Winery label, had a good reputation in the wine industry which could properly be valued at five times its annual income (R. 44). No mention of the use of such label or trade name was, however, made in the telegrams or the memorandum agreement previously referred to. No restriction on the continued use of the name by Grace was embodied therein. Since the taxpayer continued to grow grapes (R. 64) the *opportunity* for its return to the wine-making business was ever present. Moreover, Grace was unable to state whether or not Garrett & Company in fact ever used the DeTurk wine label (R. 92). Finally, within 15 months the right to the use of that label or trade name was again apparently abandoned by Garrett when it yielded up its rights to the winery to Grace. All of this evidences a startling lack of interest by both parties in this trade name which had a value according to the taxpayer of a substantial portion of the \$100,000 allegedly paid in excess of the value of the inventory.

The absence of documentary evidence. From the foregoing it appears that the taxpayer's entire case must be sustained upon the testimony of Grace alone

for nowhere is there the slightest written evidence to aid the taxpayer. Yet not only were Grace and Weller involved in this transaction but there was testimony (R. 52-53) regarding conversations with other persons about the sale of the taxpayer's business as a unit and (R. 69-70) concerning discussions between Grace and his wife, both members of the board of directors, about the decision to dispose of the winery. But the testimony of none of the persons with whom such conversations were allegedly held was offered by the taxpayer. And, more significantly, it would seem that where at least four or five individuals deal in a transaction involving a quarter of a million dollars some writing would be made at some point in the negotiations in which mention would be made of so vital a factor as the disposition of good will, the right to engage in the business and the use of the trade name. But, as previously stated, not a word appears any place concerning restrictions upon the taxpayer's continued dealings in the wine business in competition with Garrett, its use of the DeTurk Winery label or continued solicitation of the list of customers transferred to Garrett.⁷

For all of these reasons therefore we submit that the factual case attempted to be made by the taxpayer falls before the weight of the record.

Before the Tax Court, as here (Br. 22-35), the taxpayer sought the aid of a legal presumption to demonstrate that it had sold its good will. The presumption relied on is to the effect that a profitable business is deemed to have a good will value and when

⁷ Assuming, *arguendo*, that all the valuable tangibles and intangibles which go to make up the good will of a going business were contracted for by the parties, there would remain a serious doubt as to the value to the purchaser of such good will transferred without the slightest restraint on its immediate impairment by a seller who might reengage in the same business the very next day.

sold in its entirety a part of the consideration paid is attributable to such good will whether or not the contract of sale so specifies. *White & Wells Co. v. Commissioner*, 19 B.T.A. 416, affirmed, 50 F. 2d 120 (C.C.A. 2d); *Pfleggar Hardware Specialty Co. v. Blair*, 30 F. 2d 614 (C.C.A. 2d).

The Tax Court properly held (R. 26-27) that the presumption referred to could not apply to the facts of this case since the taxpayer had failed to prove that the entire business including good will of a value of \$100,000 had, in fact, been sold.

It is self-evident that if the transfer of an entire business carries with it a factor of good will, one must show that an entire business has been transferred in order to sustain the contention that the good will has been conveyed. And we think it would unduly burden this discussion to refer again to the numerous factual portions of the record which demonstrate beyond debate that the transaction merely involved the sale of the taxpayer's wine inventories and the lease of its plant and equipment.

Moreover, the record further shows (R. 61-62) that in April 1944 when the taxpayer sold the winery and its equipment to Taylor and Company for a price of \$150,000, its cost basis was about \$51,000 so that it realized a gain of \$99,000. If we compare the gain so realized with Grace's estimate of \$100,000 for the entire good will of the business—or as he said (R. 62) “for the whole thing”—it becomes apparent that if any consideration was received by the taxpayer for its good will it was received in 1944, on the sale of its plant and equipment to Taylor and Company.

B. The Tax Court correctly held that the sale of the taxpayer's wine inventory and the lease of its winery was not the disposition of a "unitary business"

The taxpayer urges (Br. 39-42) that since the De-Turk Winery business was one of several different business operations in which it was engaged its disposition as a going concern was the sale of an entire business which should be taxed as a sale of a capital asset. The taxpayer recognizes (Br. 41) that its argument on this phase of the case rests on the same fact basis as the first contention. And the Tax Court dismissed this alternative argument since it could not accept the "factual premise" (R. 27) upon which it was based. The transaction, it held (R. 28), "was not single, but comprised a sale of wine and barrels and the lease of a winery". Reference was made to the fact that if the entire transaction had been a unit the profit therefrom would have been includible in the taxpayer's 1942 return and not its 1943 return since the contract of sale was entered into in 1942. Moreover, the profit so reportable would include the undisclosed profit from that portion of the wine delivered in 1942 and from the sale of barrels and from rent under the five-year lease as well as the gain on the wines delivered in 1943. Furthermore, the fact that the taxpayer reported the gain on the 104,000 gallons of wine billed to Garrett as ordinary income in 1942⁸ is evidence which indicates a contrary understanding of the nature of the transaction than

⁸ In order to get "part of sales" (R. 73) in its 1942 return "for income tax purposes" (as Grace explicitly stated in his telegram of January 1, 1943—R. 74-75) a portion of the inventory (104,000 gallons having a value of \$52,000) was billed to Garrett on December 31, 1942, immediately upon consummation of the agreement to sell.

that alleged. Although it is true that the position taken in a tax return does not ordinarily preclude a reversal by the taxpayer, the situation is otherwise,^u as here, the manner in which the transaction was reported offers strong evidence of the understanding and intention of the party to, and the nature of, the transaction.

In making this argument, the taxpayer relies upon *Graham Mill & Elevator Co. v. Thomas*, 152 F. 2d 564 (C.C.A. 5th), to support its view that a sale of all of the assets of a business is not made in the course of business and therefore constitutes a sale of capital asset. Not only does this case fail to aid the taxpayer's position, but it greatly weakens it. There the court was concerned with the sale of notes and accounts receivable and held that the selling of such assets prevented the resulting loss realized from being treated as an ordinary business loss.⁹ The evidence, the court said (p. 565), showed that the taxpayer—

was not in the business of selling notes and accounts, and had never so dealt with its notes and accounts before. * * * They represented the taxpayer's business capital, but were not a part of his stock in trade.

Thus, as the Tax Court pointed out (R. 29-30), the rationale of the decision indicates that if (as in the present case) the taxpayer's normal stock in trade had been the subject of consideration the decision would have been the reverse of what it was—since stock in trade is expressly excluded from the definition of Section 117(a), Internal Revenue Code, Appendix, *infra*.

⁹ Since in the *Graham Mill* case the "goods on hand"—i.e. the stock in trade was taken by the purchaser in each instance at inventory price (p. 565) no gain or loss was realized on the inventory and the issue present in this and *Williams v. McGowan*, 152 F. 2d 570 (C.C.A. 2d), could not arise.

Moreover, the case of *Williams v. McGowan*, 152 F. 2d 570 (C.C.A. 2d), directly repudiates the taxpayer's contention. There the taxpayer sold his business "as a whole" for a price of about \$64,000. The "business" sold included cash of \$8,100, accounts receivable of \$7,000, fixtures of \$8,000, a merchandise inventory of about \$49,000, and \$1,000 of accounts payable. Having suffered a net loss upon the transaction, the taxpayer attempted to report it as ordinary loss rather than a capital loss. The question raised was (p. 572) "whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in § 117(a)(1), or whether the whole business is to be treated as if it were a single piece of property". The court held in a concise but learned analysis that the definition of capital assets under Section 117(a)(1) of the Internal Revenue Code rejects the fiction of firm assets as an indivisible interest and accordingly that as to each of the items transferred (cash, receivables, fixtures and merchandise inventory) there must be separate consideration to determine whether it falls within the definition of Section 117. The conclusion naturally followed that the fixtures and the inventory were not capital assets since the former was subject to depreciation and the latter was "stock in trade" expressly excluded from Section 117.

Thus, assuming the factual validity of the taxpayer's argument that what was sold was a "unitary business", the *Williams* case demonstrates the irrelevancy of that fact to the question of whether the assets which go to make up the business may be treated as giving rise to capital gain rather than ordinary income.

The taxpayer's reference (Br. 40) to *United States v. Adamson*, 161 F. 2d 942 (C.C.A. 9th), obviously is

wide of the mark for that case held only that the disposition of certain rights in two contracts and against a judgment debtor constituted the sale of capital assets. It had no possible bearing on the sale of stock in trade in a going business.

Thus, since there is no factual basis for the view that a single capital item was sold and, for the further reason that the legal rule established by *Williams v. McGowan* precludes such a result, the Tax Court's conclusion that the profit from the sale under consideration was ordinary income is clearly correct.

C. The Tax Court correctly held that the taxpayer's wine inventory did not lose its character as stock in trade or as property held primarily for sale to customers in the ordinary course of trade or business by virtue of the taxpayer's decision to discontinue its wine business

The taxpayer's final contention (Br. 42-46) is that its wine inventory was converted into a capital asset when the decision was made to dispose of its winery business, and that the gain realized upon the sale of such a capital asset constitutes long term capital gain. The Tax Court held (R. 28-30) that a decision to liquidate one's business does not change the character of its stock in trade. The essential factor is, of course, the character of the property sold. Stock in trade may under the proper circumstances be converted into a capital asset. But the change will take place not merely by the decision of the taxpayer to sell *all* his inventory (a result generally hoped for by all inventory sellers) but by the modification of the use or purpose to which the property is placed. Thus, one who sells carpentry tools may convert them into capital assets by using them *as tools* rather than as stock in trade to be sold to customers.

In any event on this issue the holding of *Williams v. McGowan*, *supra*, is again decisive. There, as here, a decision to dispose of a going business was without effect on the character of the gain or loss on the separate assets to be sold.

In essence, this has been the view taken by this Court. Thus, in *Commissioner v. Boeing*, 106 F. 2d 305 (C.C.A. 9th), certiorari denied, 308 U. S. 619, it was held immaterial that a taxpayer engaged in the sale of cut logs from lands owned by him was motivated by *a desire to liquidate his investment*. The gain resulting from such sales—being from his “trade or business”—was ruled ordinary income. In the instant case, the wine sold was admittedly the stock in trade of the taxpayer. Since that factor was the basic question at issue in the *Boeing* case, it would appear that the same result should follow *a fortiori* in the present case. See also *Richards v. Commissioner*, 81 F. 2d 369, 373 (C.C.A. 9th), in which the motive to liquidate was likewise deemed without consequence on the sale of assets sold in the course of business.

The cases on which the taxpayer relies (*Three States Lumber Co. v. Commissioner*, 158 F. 2d 61 (C.C.A. 7th); *Adamson v. Commissioner*, decided December 11, 1946 (1946 P-H T. C. Memorandum Decisions, ¶ 46,286)) fail, on analysis, to lend any weight to this argument. The *Three States* case involved the sale of timber land whose value as a lumber producing asset had been exhausted. The sale was held (p. 64) to be an “orderly liquidation” of “capital assets [which had *always* been capital assets in the hands of the taxpayer] which no longer furnished income”. The case is clearly no authority for the view that stock in trade is converted into a capital asset merely because of the taxpayer’s decision to liquidate his

entire inventory. The *Adamson* case, already discussed *supra*, held only that the assignment of certain judgment rights against a debtor for, and certain reversionary rights in, a patent and trademark constituted a sale of capital assets since the taxpayer was not in the business of selling patents and trademarks. There was no issue as to the conversion of a non-capital asset to a capital asset.

By way of anticipating a further objection to its final contention, the taxpayer has also cited *Lurie v. Commissioner*, 156 F. 2d 436 (C.C.A. 9th), and *Commissioner v. Gracey*, 159 F. 2d 324 (C.C.A. 5th). These cases are submitted to fill the factual gap—not met by the argument that a conversion was effected—that in any event the so-called “capital assets” were not held for the statutory period of six months necessary to give rise to *long term* capital gain. (Section 117(a)(4), Internal Revenue Code, Appendix, *infra*.) Neither case is in point.

Lurie v. Commissioner, *supra*, involved the question whether amounts paid on the retirement of coupon notes should be considered as amounts received “in exchange therefor”, under Section 117(f), Internal Revenue Code, since only by virtue of that special provision is the retirement of a security regarded as the “exchange” of a capital asset. It needs no more to show that the case is irrelevant on the question whether stock in trade is subject to being “converted” must be held for more than six months thereafter in order to obtain the benefit of capital gains treatment.

The *Gracey* case, *supra*, likewise involved a section, Section 117(h)(1), Internal Revenue Code, which has no application to stock in trade, but which merely governs *exchanges* of one asset for another, in which event the holding period for the property transferred may be added to the period during which the property

received is thereafter held. But again, the reason lies in the express exception of Section 117(h)(1) to the general rule—an exception not accorded a taxpayer's inventory or stock in trade.

It is submitted, therefore, that stock in trade cannot be converted to a capital asset merely by a desire to liquidate; in any event, that such a "converted asset" must be held for more than six months to give rise to capital gain.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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DECEMBER, 1948.

APPENDIX

Internal Revenue Code:

SEC. 22 [as amended by the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1]. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 117 [as amended by the Revenue Act of 1941, c. 412, 55 Stat. 687, Sec. 115, and the Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 150 and Sec. 151]. CAPITAL GAINS AND LOSSES.

(a) *Definitions*.—As used in this chapter—

(1) *Capital Assets*.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the

United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

(2) *Short-Term Capital Gain*.—The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(4) *Long-Term Capital Gain*.—The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(6) *Net Short-Term Capital Gain*.—The term “net short-term capital gain” means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year;

* * * * *

(10) *Net Capital Gain*.—

(A) *Corporations*.—In the case of a corporation, the term “net capital gain” means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges;

* * * * *

(26 U.S.C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22(a)-10. *Sale of Good Will*.—Gain or loss from a sale of good will results only when the business,

or a part of it, to which the good will attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including good will. (See sections 29.111-1, 29.113(a)(14)-1, and 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive.) If specific payment was not made for good will, there can be no deductible loss with respect thereto, but gain may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or other basis of the good will sold.

* * * * *

SEC. 29.117-1 *Meaning of Terms.*—The term “capital assets” includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a “capital asset,” the period for which held is immaterial.

The exclusion from the term “capital assets” of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23(1) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See section 29.117-7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term “capital assets” even though depreciation may have been allowed with respect to such property under section 23(1) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land

held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c), and (d). The term "ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

* * * * *

Example (2). * * *

Section 117(a) (2) to (9), inclusive, defines "short-term capital gain," "short-term capital loss," "long-term capital gain," "long-term capital loss," "net short-term capital gain," "net short-term capital loss," "net long-term capital gain," and "net long-term capital loss." These terms are used in the subsequent subsections of section 117.

The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for six months or less; the phrase "long-term" to the category of gains and losses arising from the sale or exchange of capital assets held for more than six months. The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 117(d) does not mean that such loss is not "taken into account in computing net income" within the meaning of that phrase as used in section 117(a) (3) and (5).

In the definition of "net short-term capital gain," as provided in section 117(a)(6), the amounts brought forward to the taxable year under section 117(e) are short-term capital losses for such taxable year.

Gains and losses from the sale or exchange of capital assets held for not more than six months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than six months (described as long-term capital gains and long-term capital losses). The percentage brackets of section 117(b) have no application to corporations, corporate gains and losses being taken into account to the full extent, without regard to the length of time the

capital assets are held (though because of the limitation in section 117(d) such losses may not be deductible in full).

Section 117(a)(10) defines "net capital gain." In the case of a corporation the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges, which losses include any amounts brought forward pursuant to section 117(e).

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